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Thank you for the opportunity to appear again before this distinguished Committee. I compliment you on the additional protections accorded to investors in the "Mutual Funds Integrity and Fee Transparency Act of 2003," especially the sections calling for disclosure of the dollar amount of annual operating expenses borne by each shareholder, the increase in the number of fund independent directors to two-thirds of the board, and the requirement that the fund chairman be an independent director.

In candor, however, I would hope that the final legislation will go further. For I believe that this industry has not adequately measured up to its responsibilities to mutual fund investors. While the express language of the preamble to the Investment Company Act of 1940 calls for mutual funds to be "organized, operated (and) managed" in the interests of shareholders rather than in the interest of "directors, officers, investment advisers . . . underwriters or brokers," it is simply impossible to believe that such is the case.

Fund Expenses Rise 120-Fold

Consider, for example, how fund expenses have soared over the past quarter century. Applying the data on weighted expense ratios (recently submitted to the Committee by the Securities and Exchange Commission) to fund net assets, the *dollar amount* of fund expenses rose from $523 *million* in 1979 to $31 *billion* in 1996, to $64 *billion* in 2001. And in 2002, fund expenses totaled $62 billion, even more than 1999's $58 billion, despite the 34% erosion in their capital suffered by equity fund shareholders during the three-year bear market period ended

March 31, 2003. In my personal experience, the economies of scale in this industry are staggering, and it would be simply incredible to argue that they have been adequately shared with fund owners.

The expense disclosure and increased director independence called for in the legislation should help limit future increases in fund expense ratios, but I believe the addition of a section in the 1940 Act is also necessary. It would call for an express standard of fiduciary duty on the part of directors to act in precisely the manner called for by the preamble: *A fiduciary duty to place the interests of fund shareholders ahead of the interests of fund managers and underwriters*.

I also urge the Committee to require mutual funds to report their estimated portfolio transaction costs to investors. These numbers are not nearly as mysterious as they are portrayed, and are in fact frequently calculated for fund managers by independent services, and, at least in some cases, shared with fund directors. I see no reason that transaction costs should not be shared with fund shareowners as well.

The Impact of Costs

Bit by bit, investors are learning the important role that costs play in reducing the share of financial market returns that fund investors receive. Adding together the average equity fund expense ratio plus turnover costs, plus sales charges, plus opportunity costs and out-of-pocket fees, all-in costs come to between 2½% and 3% of the investment of an equity fund owner.

But that seemingly small number is in fact powerful. If we enjoy, for example, a future stock market return of 8%, annual costs of 3% would consume nearly 40% of it, leaving 60% for the investor—who, after all, put up 100% of the capital and who took 100% of the risk. And over the long term, say, 25 years, even a 2½% cost would reduce a compound market profit of *$58,000* on a cost-free *stock market* investment of $10,000 earning 8% a year to a *$28,000* profit on a *mutual fund* that earned 5½% after costs—more than half the long-term profit confiscated by expenses.

Making the *dollar amount* of the costs they incur would help investors to become aware of the truly punishing penalty of high expenses. *Properly handled, such disclosure would be virtually cost-free to the funds*. Rather that all of the machinations surrounding showing the *actual* costs paid by an investor during the prior year, a simple report showing the *current rate* of costs would do the job. That is, simply print the fund's current expense ratio in the shareholder statement, and multiply it by the asset value of the investor's account at quarter's end (i.e., 1.40% x $17,241 = $241). The cost to the funds of this simple addition in the statement would be close to zero, a far cry from the $265 million estimate of first-year fund costs offered by the Investment Company Institute.

It is frequently alleged that the availability of low-cost funds indicates that there is ample price competition in the fund industry. *That is simply not so*. While it is true that three "low cost" fund groups hold a 26% market share of industry assets, that is a reflection of consumer choice, and does *not* reflect any significant reduction in fees charged by other firms. *Price competition is defined, not by the action of consumers, but by the action of producers*. Yet the record is clear that most of the changes in fund fee structure in recent years have been to *increase* rates, hardly evidence of competition. (Indeed, an Investment Company Institute study several years ago noted that the *lowest* cost decile of funds had actually experienced a 27% *increase* in expense ratios.)

What is more, describing a fund as "low cost" because its expense ratio is below industry norms is a circular argument, rather like describing a CEO's compensation as "low" because it is fractionally below the grotesquely excessive level of compensation of CEOs as a group. Yet it is the generally high level of mutual fund costs that has demonstrably eroded the net returns earned by fund investors.

Further Disclosure of Costs

While I applaud the section of the proposed legislation that calls for disclosure of the compensation structure of the individual portfolio managers employed by the investment adviser, I do not believe it goes nearly far enough. Not only do I believe that the *actual amount* of such compensation be disclosed, but the idea that it's too complicated to deal with compensation for management teams or managers of multiple funds strikes me as an inadequate basis for depriving fund owners of the information to which they are entitled.

But even that disclosure is not enough. I estimate, for example that, of the approximately $62 billion of fund expenses in 2002, only about $4 billion represented compensation for investment advisory services—portfolio managers, security analysts, traders, support staff, and overhead. I believe that shareholders of the funds are entitled to know not only the aggregate expenses of the funds they own, but *where that money goes*. Specifically, fund managers should report the salaries of senior officers, expenditures on investment advisory services, on marketing and advertising, and on operations and administration, as well as the remaining net income of the adviser, both before and after taxes. In addition, fund shareholders have a right to know how those profits are divided among the major individuals and corporations that own the adviser's shares, often the major source of compensation of executives.

Such disclosures, of course, are quite typical among ordinary business corporations. But in this peculiar mutual fund industry, such disclosure has been stymied by the fact that the fund's payments are largely made a separate corporation, and, as it has been argued, "the corporate veil cannot be pierced." In the extraordinary structure of the mutual fund industry—in which the advisor controls the fund and is typically the sole provider of all investment, distribution, and marketing services, and in which the adviser negotiates (or fails to negotiate) its fees with, as it were, *itself* (it can even sell itself to an outside financial conglomerate, which is tacitly assured that the huge capital commitment required in its purchase will be rewarded by a continuing contractual relationship with the funds)—it is high time that, in this age of full disclosure, the disclosure of all relevant financial information to shareowners becomes an accepted part of mutual fund investing.

I'm not arguing that most fund investors are demanding—or even care about—this information. Rather, I'm arguing that, once exposed to the sunlight of disclosure, the behavior of fund managers will change. It will lead to substantial reductions in costs, and will therefore materially enhance the returns that shareholders receive.

Free From Scandal?

I would like to close by commenting on the conventional industry allegation, accepted by the SEC, that the fund industry must be good because it has never had a major "scandal." Yet if a scandal is defined as "a grossly discreditable condition of things," it is not clear that the statement is accurate.

- Shareholder Returns vs. Stock Market Returns: During the past 20 years, the U.S. stock market has earned a return of 13% per year, while the average mutual fund investor has earned a return of approximately 2% per year. An initial investment of $10,000 in the stock market, then, would have earned a profit of $105,000, while the average fund owner would have earned a profit of just $5,000. *Is that a scandal, or is it not?*
- Part of that lag in returns is the responsibility of the fund industry. During the period leading up to very top of the market bubble, we created, and offered to investors, 494 new technology, telecom, and internet funds, and aggressive growth funds favoring these sectors. (Referring back to the 1940 Act's preamble, is it even *remotely* possible that these funds were "organized, operated, and managed" in the interest of investors rather than in the interests of fund distributors?) *Is that a scandal, or is it not?*
- These new funds, and similar aggressive funds that were organized earlier, took in $490 billion—almost one-half a trillion dollars!—at the worst possible time. It was not only the stock market mania and investor greed of the era that drew these assets into those funds. Fund managers not only formed these funds knowing they were likely to fail—or *not* knowing it; I'm not sure which is worse—but vigorously engaged in marketing and advertising the returns that these funds had achieved during the bubble. For example, in the March 2000 issue of *Money* magazine, just as the market crash was about to begin, 44 mutual funds advertised their average returns during the prior year. The average return of these funds: +85.6%. *Is that a scandal, or is it not?*

The industry that I have been a part of for my entire 52-year business career, it seems to me, has a severe case of the "Emperor's Clothes Syndrome," failing to see what is obvious to all who only open their eyes. While not a single one of the men and women that I've met over my career has been other than a good, capable, honest, human being, I believe that the powerful financial interests our industry's executives hold in the companies that manage the funds has blinded them to the realities I've described today. Yet in the long run, we in this industry will grow only as fund shareholders are given a fair shake, not only in costs and disclosure, but also in having truly independent directors who put their interests first, and in retaining managers whose highest priority is not salesmanship, but stewardship. Saying that "my costs are fine" as long as they don't materially exceed industry norms is simply not good enough.

While considerable progress is being made, we need more than the valuable advances called for by the legislation before this Committee that would provide better cost disclosure and strengthen the independence of fund directors. This industry needs, well, a change of heart, one in which our very focus changes—from placing the interests of *managers* first to placing the interests of *shareholders* first. The Congress can't mandate, as far as I know, such a change of heart. But even taking the steps contemplated in the legislation before this Committee, to which I hope will be added the recommendations I've made in this statement, will at least begin the process of serving, just as the 1940 Act sought, "the national public interest and the interest of investors."